DEPARTMENT OF ECOLOGY State of Washington

CTED | Community, Trade and Economic Development

Preventing Market Manipulation

Proposed Regional Cap-and-Trade Program

A design for a regional market-based climate program that reduces global warming pollution to promote a thriving economy and protect public health

Overview

When the Western Climate Initiative (WCI) cap-and-trade program is implemented, it will create new markets for emission allowances, or permits to emit greenhouse gases. These new markets need to be protected from *market manipulation.* Market manipulation is when individuals or groups intentionally interfere with a market's fair operation. Even though manipulation is illegal under the U.S. Securities Exchange Act, it is important to prevent potential manipulation or excessive speculation of the allowance market. If the market is not protected, there could be price disruptions that would:

- Undermine the functioning of the market.
- Create a lack of confidence in the market.
- Raise costs for regulated facilities and entities.
- Ultimately fail to reduce greenhouse gases.

Potential for market manipulation

Preventing market manipulation is a top priority of Ecology and CTED. Operating under a contract with Ecology, ICF International was asked to examine the potential for manipulation of the allowance market and recommend options for limiting this type of behavior.[1] Three primary areas of the allowance market are of concern:

1. Auction design and operation
2. Market oversight
3. How and when certain information is disclosed

The general findings of the study were:

- There is no evidence of market manipulation in existing cap-and-trade programs -- US Sulfur dioxide (SO_2), nitrous oxide (NO_x) or the European Union's Emission Trading Scheme (EU-ETS).
- The Commodities Futures Trading Commission, Federal Energy Regulatory Commission, and the Security and Exchange Commission will all likely have oversight responsibility for some portion of the WCI allowance market.
- Allowance markets bear no resemblance to electricity markets because:
    - Carbon allowances will be much more broadly owned, making it difficult for a handful of bad actors to create a shortage.
    - Carbon allowances can be banked unlike electricity credits that cannot be banked.

- There are no "critical" times for carbon allowances – there is a three-year compliance period that allows ample time for covered facilities and entities to acquire the necessary allowances. Electricity demand on the other hand must be met instantly to maintain system reliability.

Specific recommendations from ICF included that the WCI jurisdictions should:

- Contract with an independent market monitor to provide monitoring and oversight as Regional Greenhouse Gas Initiative (RGGI) did.
- Adopt the "beneficial ownership"[2] disclosure requirements, also as RGGI did.
- Use the "single-round, uniform price" for any auctions they conduct.

The WCI jurisdictions have formed a new subcommittee on Market Operations and Oversight. Preventing manipulation and excessive speculation are primary tasks of this subcommittee. The WCI jurisdictions will work with RGGI on lessons learned from its initial auction and how it oversees its allowance market. The states also expect to work with EPA, which has successfully operated the SO_2 and NO_x cap-and-trade programs. The WCI Partners will also consult key stakeholders such as utilities on program design.

More information

Washington's Climate Change Web site
www.ecy.wa.gov/climatechange/index.htm

Cap–and-Trade Reports
www.ecy.wa.gov/climatechange/2008CT_reports.htm

Contacts

Department of Ecology

Janice Adair
jada461@ecy.wa.gov
(360) 407-0291

Department of Community, Trade and Economic Development
Tony Usibelli
tonyu@cted.wa.gov
(360) 725-3110

Special accommodations:

If you need this publication in an alternative format, call the 360-407-7000. Persons with hearing loss, call 711 for Washington Relay Service. Persons with a speech disability, call 877-833-6341.

[1] The paper is now available on Washington's climate change Web site: http://www.ecy.wa.gov/climatechange/2008CTdocs/10102008_LimitingMarketManipulation.pdf.
[2] This requires that every participant must disclose the party sponsoring or benefiting from the agent's activities in the allowance market if it was other than themselves or their immediate employers.